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450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082
TELEPHONE (916) 324-2623
FAX (916) 323-3387
www.boe.ca.gov

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June 25, 2004

Re: *Application of Parent-Child Exclusion to Leases Between Children and Trusts with Mother as Trustee and Sole Beneficiary—Revenue and Taxation Code section 63.1*

Dear Mr. _____ :

This is in response to your e-mail, dated February 18, 2004, to Ms. Kristine Cazadd requesting our opinion regarding the application of the parent-child exclusion in Revenue and Taxation Code section 63.1¹ to a series of transfers between several family trusts, a limited partnership (LP), and a limited liability company (LLC), culminating with leases of 35 years or more between the trusts and you and your three siblings (“the four children”). You believe the various transfers described should be excluded from change in ownership. In particular, you believe the parent-child exclusion should exclude the leases from being changes in ownership.

For the reasons set forth below, we conclude that the transfers prior to and following the lease transactions are excluded from being changes in ownership by section 62, subdivisions (a)(2), (d), and (g), and section 63. We also conclude that the transfer of a principal residence and all other real property up to the amount of \$1 million of full cash value are excluded from changes in ownership under section 63.1.

Factual Background

You state that your parents established a revocable inter vivos trust. At your father’s death on January 9, 1996, the trust became irrevocable and divided into four separate trusts: 1) The Survivor’s Trust; 2) the Family Trust; 3) the Marital Trust; and 4) the Grandchildren’s Trust. You indicate a portion of your mother’s share of the community property funded the Survivor’s Trust, while a portion of your father’s share of the community property funded the Family Trust, utilizing his applicable estate tax credit. The balance of your parents’ (community) property funded the Marital and Grandchildren’s Trusts. The bulk of your parents’ estate consists of real property. Your mother is still living, and is the sole present beneficiary of all four trusts. You state that all four trusts designate the four children to receive the remainder interests in the trusts at your mother’s death.² The division of the trust remainder, however, is

¹ All section references are to the Revenue and Taxation Code unless stated otherwise.

² We query whether this applies to the Grandchildren’s Trust given that its name implies the grandchildren are the remainder beneficiaries.

not to be in equal shares; you and your brother are each to receive one-third interests, while your two sisters are each to receive one-sixth interests.

You state that the Survivor's Trust, the Marital Trust, and the Grandchildren's Trust transferred 97 percent of the real property interests into a LP, apparently in exchange for proportional interests in the LP.³ Each of the trusts then transferred a one percent real property interest into an LLC, apparently in exchange for proportional interests in the LLC.⁴ The LLC, in turn, transferred the real property interests to the LP and became the general partner of the LP. It is now proposed to reverse the property transfers to the LP and the LLC to return the real property to the trusts in the same proportions as each trust originally contributed to the LP and the LLC. The three trusts would then execute a lease agreement with the four children for each of the properties held in trust. The lease period for all the leases would be for 35 years or more. The trusts would then transfer their lessors' interests back to the LP and the LLC in the same proportions in which the trusts originally contributed the real property interests. Each child's leasehold interests would be in the same percentages as their remainder interests in the real property, i.e., you and your brother would each hold a one-third interest in each leased property and your sisters would each hold a one-sixth interest in each leased property.

Law and Analysis

Section 60 defines a change in ownership as (1) a transfer of a present interest in real property, (2) including the beneficial use thereof, (3) the value of which is substantially equal to the value of the fee interest. (*Pacific Southwest Realty Co. v. County of Los Angeles* (1991) 1 Cal.4th 155, 162.) Section 62, subdivision (d), in relevant part, excludes from change in ownership transfers of real property by a trustor into a trust for as long as the trustor is the present beneficiary or the trust is revocable. Section 62, subdivision (d), thus excluded from change in ownership the transfer of real property by your parents into the original revocable inter vivos trust.

Upon your father's death, another series of transfers occurred when the original trust became irrevocable and subsequently divided into four separate trusts. Your father's interests in the real property transferred from the original trust to the subsequently-created trusts according to the terms of the original trust. Section 63, which excludes from change in ownership real property transfers between spouses during their lives and at death, excluded the transfers of your father's interests in the real property from the original trust to the subsequently-created trusts because each trust named your mother as the sole present beneficiary. Although the real property interests before the transfers and the LP and LLC interests after the transfers are held in the trusts, your mother is the present beneficial owner of the interests. As previously stated,

³ Apparently, the Family Trust is not involved in the transactions at issue. Thus, any references to "the trusts" or "the three trusts" refers to the Survivor's Trust, the Marital Trust, and the Grandchildren's Trust.

⁴ The percentages transferred by the trusts to the LP and LLC vary between your initial e-mail request of February 18, 2004, and your supplemental e-mail dated April 22, 2004. In your initial e-mail, you state the trusts transferred 97 percent of the real property to the LP and 3 percent to the LLC. In your supplemental e-mail, you state that each of the three participating trusts contributed 1 percent of the real property to the LLC, which implies that each trust contributed a 99 percent interest in real property to the LP. The disparity, however, is not critical to our conclusion.

section 62, subdivision (d), excludes from a change in ownership “[a]ny transfer by the trustor, or by the trustor’s spouse, or by both into a trust for so long as (1) the transferor is the present beneficiary of the trust, or (2) the trust is revocable.” Your mother is the sole present beneficiary of the irrevocable trusts (the Marital Trust and the Grandchildren’s Trust) and the Survivor’s Trust is revocable. Your mother therefore is the owner of the assets of the trusts. Thus, with respect to the transfers of your mother’s interests in the real property from the original trust to the subsequently-created trusts, section 62, subdivision (d), excluded those transfers because she was the trustor of the revocable trust (the Survivor’s Trust) and the sole present beneficiary of the irrevocable trusts (the Marital Trust, the Family Trust, and the Grandchildren’s Trust). (See Eisenlauer letter, dated Sept. 30, 1993, attached.)

You next describe the transfers of real property from the three trusts to the LP and the LLC as being proportional. Specifically, you state each trust received a percentage of the ownership interests in the LP or the LLC proportional to the percentage of real property interests contributed by the trust to the entity. Additionally, the LLC contributed the real property interests it received from the trusts to the LP and took back a general partnership interest in the LP. Section 62, subdivision (a)(2), excludes from a change in ownership any transfer of real property between legal entities, such as between a trust and a limited partnership or a limited partnership and a limited liability company, resulting solely in a change in the method of holding title to the real property and in which the proportional ownership interests of the transferor and the transferee in each piece of real property remain the same after the transfer. In this case, the proportionality of ownership interests is maintained because your mother owned 100 percent of beneficial interest in the real property as trustor and sole present beneficiary of the trusts before the transfers and holds 100 percent of the real property interests through the medium of the LP and the LLC after the transfers. Section 62, subdivision (a)(2), thus excluded from change in ownership the real property transfers between the three trusts and the LP and the LLC. Section 62, subdivision (a)(2), will also exclude proportional transfers of the real property from the LP and the LLC to the trusts.

Once the real property is transferred back to the three trusts, you state that the trusts will lease interests in each property to the four children; the period of each lease will be 35 years or more. You state that you believe section 63.1 will exclude the lease transactions from constituting changes in ownership. Section 63.1 provides for an exclusion from change in ownership for the transfer of certain real property⁵ between parents and their children. “Transfer” is defined in section 63.1, subdivision (c)(9), to include “any transfer of the present beneficial ownership of property from an eligible transferor⁶ to an eligible transferee.⁷” The creation of a leasehold interest in real property of 35 years or more is a change in ownership, and thus a

⁵ Section 63.1 excludes from a change in ownership “the purchase or transfer of real property which is the principal residence of an eligible transferor,” or “the purchase or transfer of the first [\$1 million] of full cash value of all other real property of an eligible transferor.” (Rev. & Tax. Code, § 63.1, subd. (a)(1) & (2).)

⁶ Section 63.1, subdivision (c)(6), defines an “eligible transferor” as a “grandparent, parent, or child of an eligible transferee.”

⁷ An “eligible transferee” is defined in section 63.1, subdivision (c)(7), as “parent, child, or grandchild of an eligible transferor.”

transfer of a present beneficial interest in real property. (Rev. & Tax. Code, § 61, subd. (c)(1).) Thus, the first portion of the definition of transfer in subdivision (c)(9) is satisfied.

We next turn to decide whether the transfer occurs from an eligible transferor to an eligible transferee, the second portion of the definition. As previously discussed, although the property is titled in the name of the trust (legal title), your mother holds the present beneficial interest in the trust property (beneficial title) as the trustor and as the sole present beneficiary. She thus would be deemed the transferor of the property in the lease transactions, rather than the trusts.⁸ As a parent of the four children-transferees, your mother is an eligible transferor. In turn, the children are eligible transferees by being the children of your mother. The leases would thus constitute transfers of the present beneficial ownership interests in property from your mother to the four children, and therefore would constitute a transfer within the meaning of section 63.1, subdivision (c)(9). As you contend, section 63.1, subdivision (a) serves to exclude the lease transactions from being changes in ownership.

The parent-child exclusion applies to the eligible transferor's principal residence and to the first \$1 million of full cash value of all other real property of an eligible transferor. (Rev. & Tax. Code, § 63.1, subd. (b)(2).) The property value limits apply separately to each eligible transferor, meaning that each parent may transfer \$1 million of full cash value of all other real property for a combined exclusion of \$2 million. (*Id.*, § 63.1, subd. (b)(2).) We previously concluded that a transfer from your mother to the four children of her principal residence and up to \$1 million of full cash value of all other real property may be excluded from change in ownership under section 63.1. The question thus becomes whether or not your father is also considered an eligible transferor for the lease transactions at issue, thus allowing an exclusion of \$2 million of full cash value (\$1 million from each parent), as opposed to only a \$1 million exclusion (from your mother only). We conclude that your father is not an eligible transferor prior to your mother's death.

Our conclusion is supported by our analysis in the attached Eisenlauer letter. In that letter, we concluded, among other things, that a transfer of a present beneficial interest in real property from a survivor's trust and a marital trust to a child at the death of the surviving spouse constituted a change in ownership and that the parent-child exclusion was allowable with respect to each transferor parent for transfers to a child only at the second death. Under the facts of that letter, the surviving spouse held the present beneficial interest in the trust property during his lifetime, and the child had only a remainder interest in the property contingent upon surviving both parents. The transfer from the parents to their child was therefore not completed until the death of the surviving spouse because of the contingent nature of the interest previously transferred to the child (future interest contingent upon the child's surviving both parents). The transfer to the child thus did not occur until the death of the surviving spouse when the child's remainder interest in the property vested.

The facts you provided appear similar to those in the Eisenlauer letter. The surviving spouse (your mother) holds the present beneficial interest in the real property. Based on the

⁸ Trusts, for property tax purposes, are not treated as separate legal entities holding ownership interests in property unless they are expressly organized for profit and registered as a business trust. (Cal. Code Regs., tit. 18, § 462.160, sub. (c).) Therefore, as all non-business trusts, it is necessary to "look through" the trust and identify the trustor and/or the beneficiaries, in order to determine the persons holding ownership interests in the property.

information you provided, it does not appear that the three trusts provide for the transfer of the real property to the four children (by lease or otherwise) prior to your mother's death, and thus the four children hold only remainder interests in the property. Since the transfers by your mother to the four children will occur during your mother's lifetime, they will not be through the medium of the trusts, or in other words, will not be pursuant to the distributive terms of the trusts. Thus, the transfers will be from your mother only, rather than from your mother and father. As a result, only the transfer of the principal residence and up to \$1 million in full cash value of all other real property may be excluded from change in ownership by section 63.1 if the property interests are leased to the children.

The final transaction you describe is for the trustee to contribute the lease interests in real property to the LP and the LLC in the same proportions as the original real property contributions. Section 62, subdivision (g), excludes from a change in ownership any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term of 35 years or more. Thus, the transfer of the trust's lessor interests to the LP and the LLC is not a change in ownership.

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Sincerely,

/s/ Reed Schreiter

Reed Schreiter
Senior Tax Counsel

Attachment [Annotation 625.0120 (C 9/30/93)]

RS:eb

Prec/Parchild/04/03-RS.doc

Prec/Trusts/04/04-RS.doc

cc: Hon. _____, County Assessor
Mr. David Gau, MIC:63
Mr. Dean Kinnee, MIC:64
Ms. Mickie Stuckey, MIC:62
Mr. Todd Gilman, MIC:70